

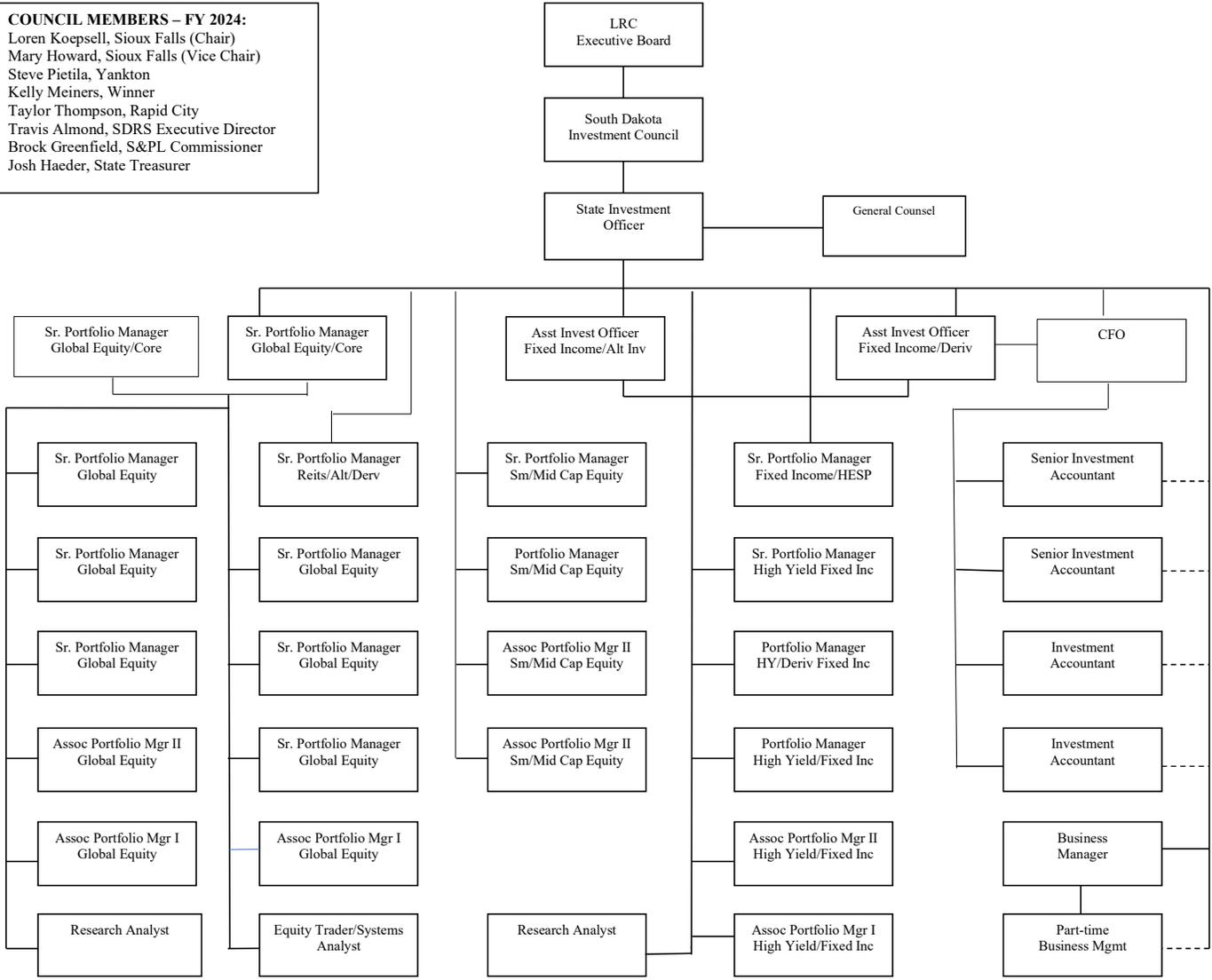


**Preliminary Estimated  
Investment Performance FY 2023 and  
Budget Request FY 2025**

PRESENTED TO  
LRC EXECUTIVE BOARD  
AUGUST 7, 2023

# Organization Chart

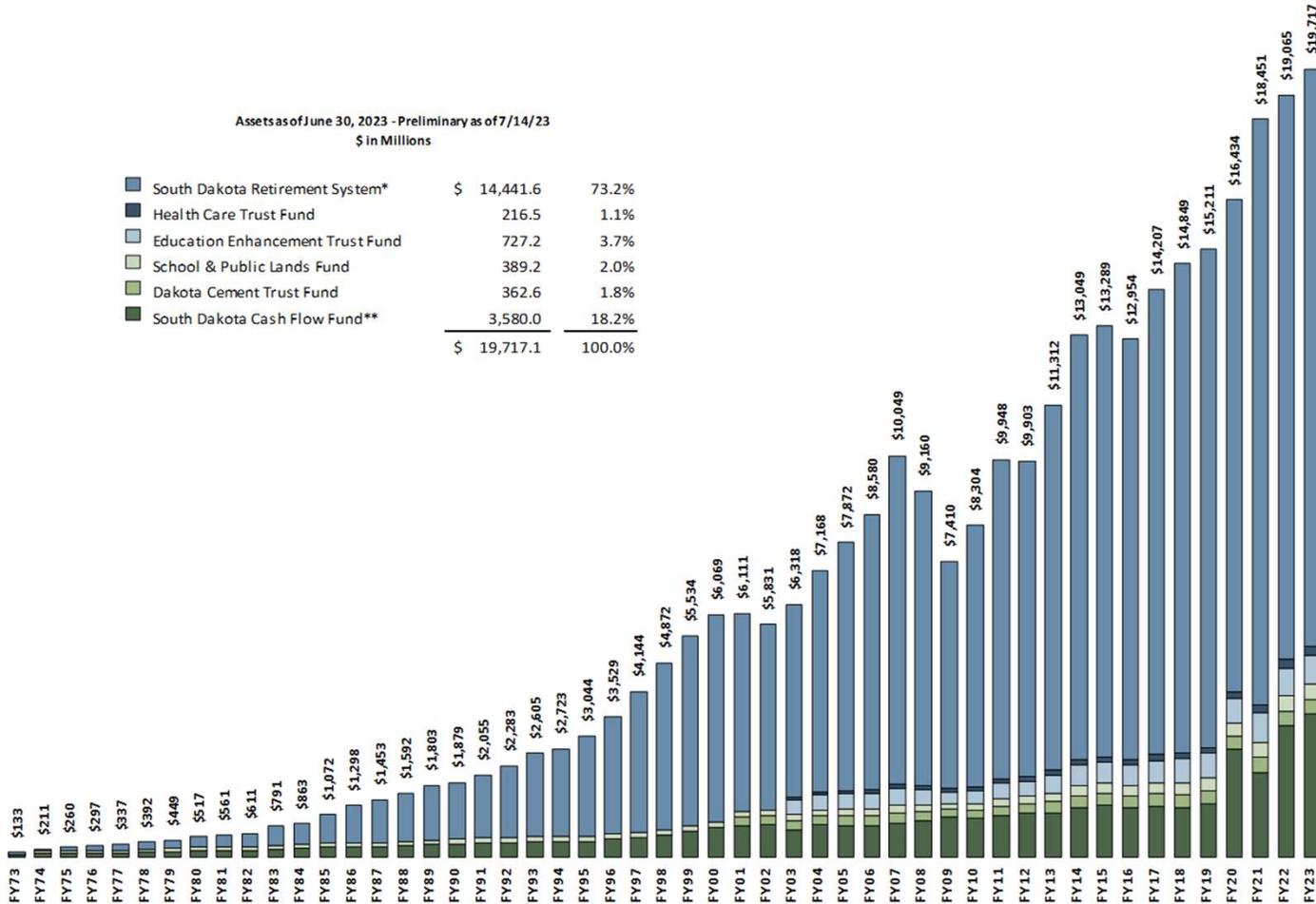
**COUNCIL MEMBERS – FY 2024:**  
 Loren Koepsell, Sioux Falls (Chair)  
 Mary Howard, Sioux Falls (Vice Chair)  
 Steve Pietila, Yankton  
 Kelly Meiners, Winner  
 Taylor Thompson, Rapid City  
 Travis Almond, SDRS Executive Director  
 Brock Greenfield, S&PL Commissioner  
 Josh Haeder, State Treasurer



# Assets (Preliminary estimates)

Assets as of June 30, 2023 - Preliminary as of 7/14/23  
\$ in Millions

South Dakota Retirement System*	\$ 14,441.6	73.2%
Health Care Trust Fund	216.5	1.1%
Education Enhancement Trust Fund	727.2	3.7%
School & Public Lands Fund	389.2	2.0%
Dakota Cement Trust Fund	362.6	1.8%
South Dakota Cash Flow Fund**	3,580.0	18.2%
	<u>\$ 19,717.1</u>	<u>100.0%</u>



\*The South Dakota Cement Plant Retirement Fund (CPRF) was consolidated into the South Dakota Retirement System (SDRS) on April 1, 2014, per SDCL 3-12C-1642. For purposes of this exhibit, CPRF Assets for Fiscal Years 1973 - 2013 are included with SDRS.

\*\*South Dakota Cash Flow Fund assets include Covid Relief Funds for Fiscal Years 2020, 2021, 2022 and 2023.

# Investment Performance

Returns vs. Benchmarks (Preliminary estimates)

	<u>FY 2023</u>	<u>5 years Annualized FY 19 - 23</u>	<u>10 years Annualized FY 14 – 23</u>	<u>20 years Annualized FY 04 – 23</u>
• SDRS Total Fund (est)*	5.51%	6.38%	7.59%	8.38%
• Capital Market Benchmark	10.65%	6.38%	7.19%	7.24%
Added Value	-5.14%	0.00%	0.40%	1.14%
• State Universe **	N/A	N/A	N/A	N/A
• Beginning FY 2023 SDRS Assets		\$14.113 billion		
• Ending FY 2023 SDRS Assets (est)		\$14.442 billion		

Note: \*Time-weighted rates of return are net of fees FY 14-23 and gross of fees FY 04-13

\*\* Not Available

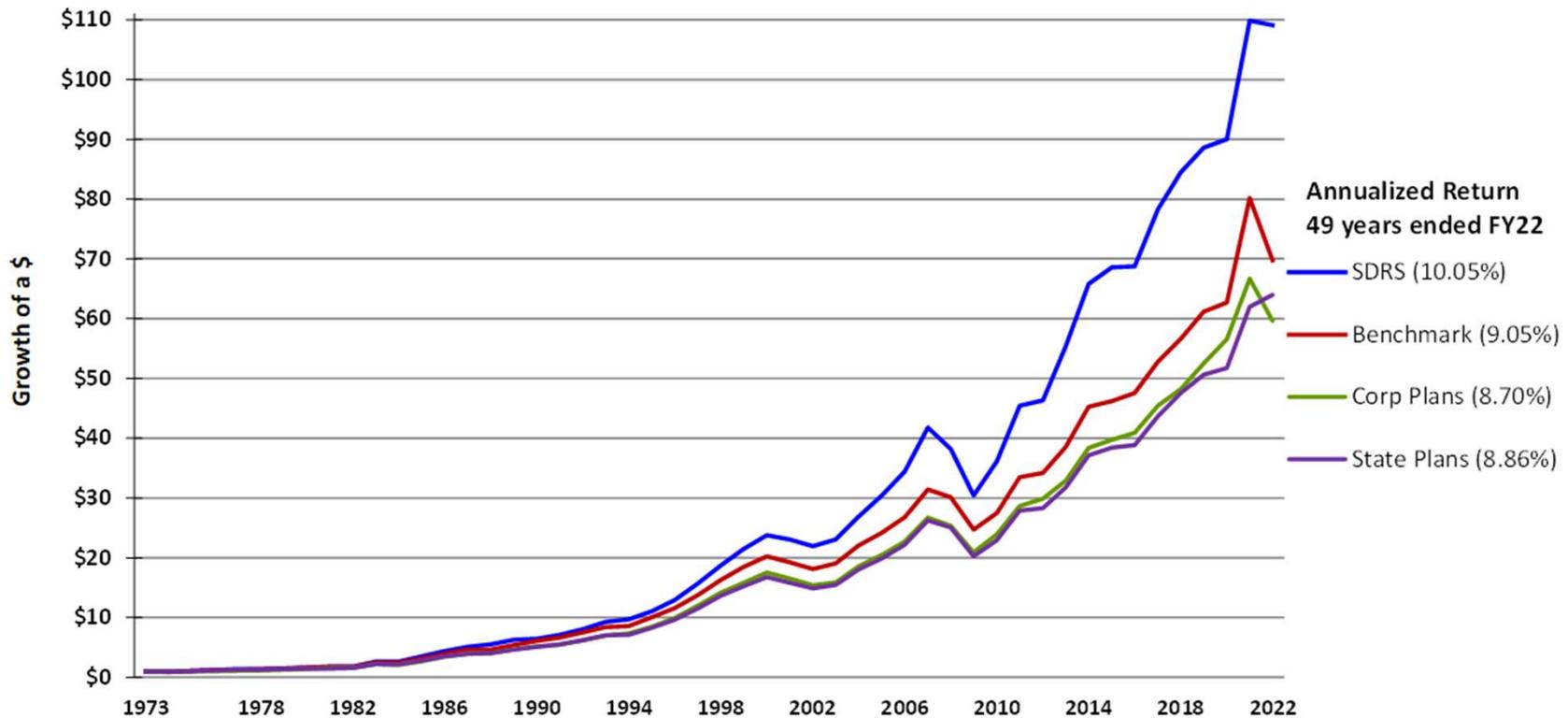
# Investment Performance

Returns vs. Benchmarks (Preliminary estimates)

- Total SDRS dollars earned Fiscal Year 2023 \$ 824.9 million
  - Total SDRS dollars earned last 5 years \$ 4.382 billion
  - Total SDRS dollars earned last 10 years \$ 9.046 billion
  - Total SDRS dollars earned last 20 years \$14.983 billion
  - **Extra earnings** resulting from performance:  
(including compounding)
    - vs Capital Markets Benchmark
- |                                | <u>1 year</u>   | <u>5 years</u> | <u>10 years</u> | <u>20 years</u> |
|--------------------------------|-----------------|----------------|-----------------|-----------------|
| ○ vs Capital Markets Benchmark | \$ -725 million | \$ -3 million  | \$695 million   | \$4.5 billion   |

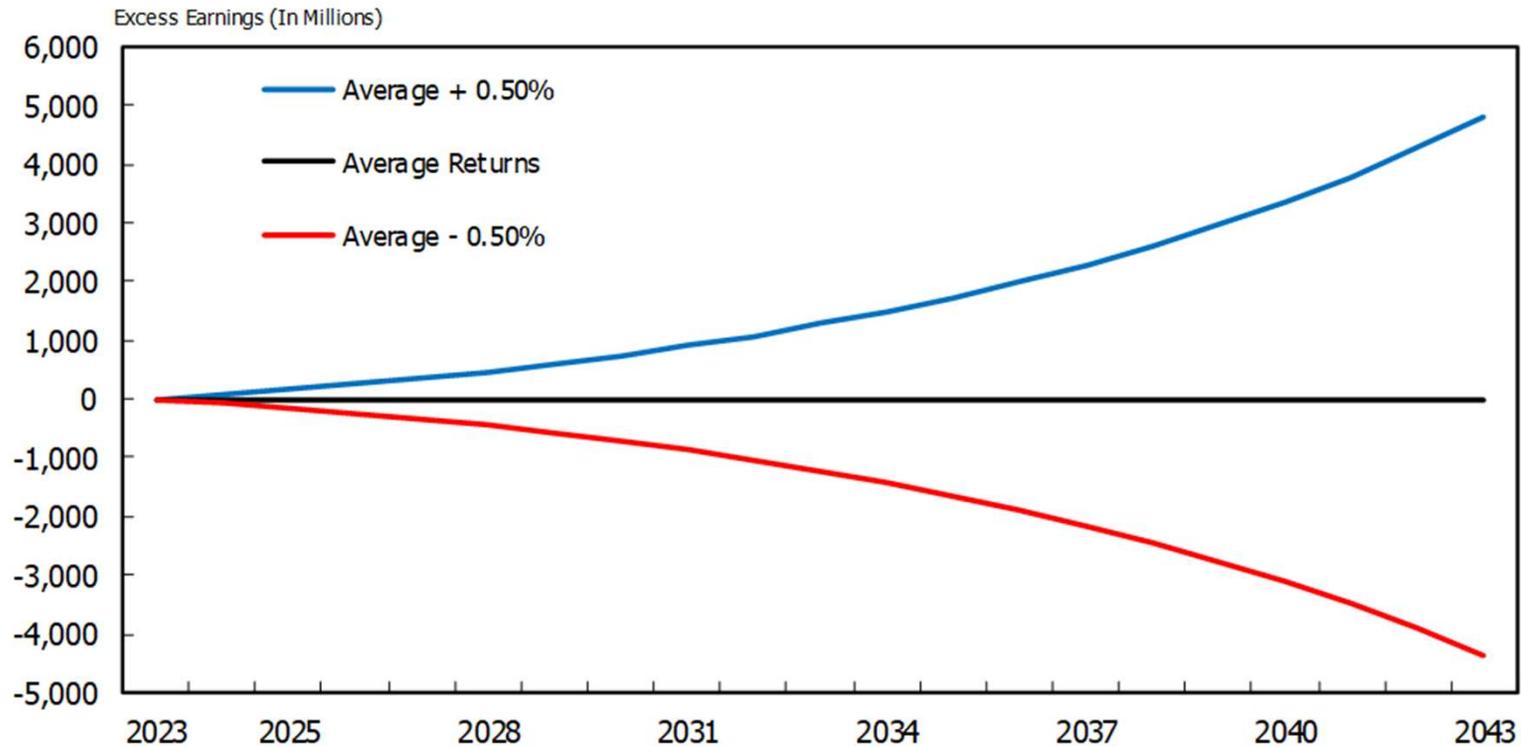
# Superior returns add up over time

Cumulative returns for SDRS, Benchmark, Corporate Plans, and other States Through FY22, will be updated when Corp & State Plans data available



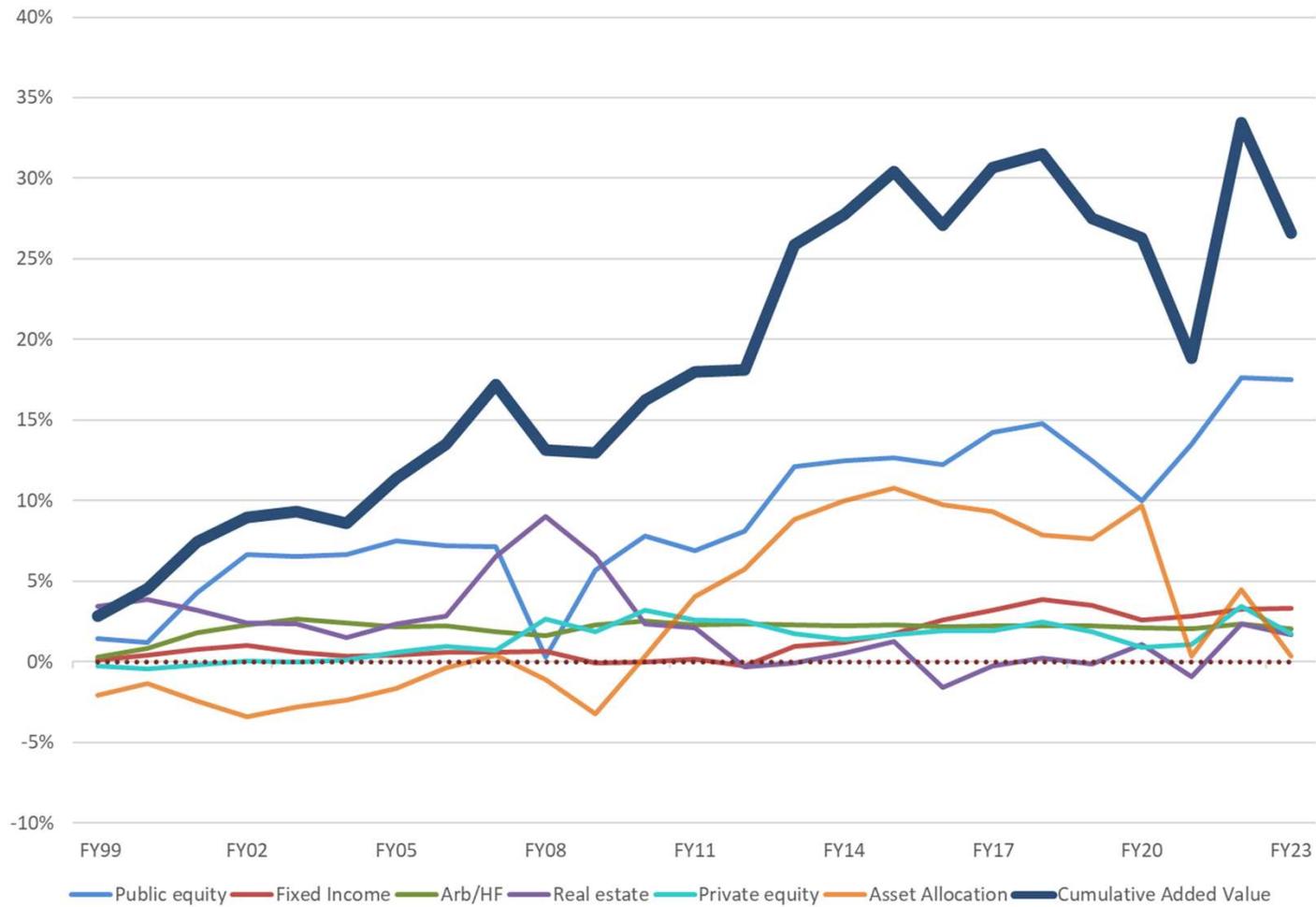
# Potential Excess Earnings

Preliminary Estimate FY23



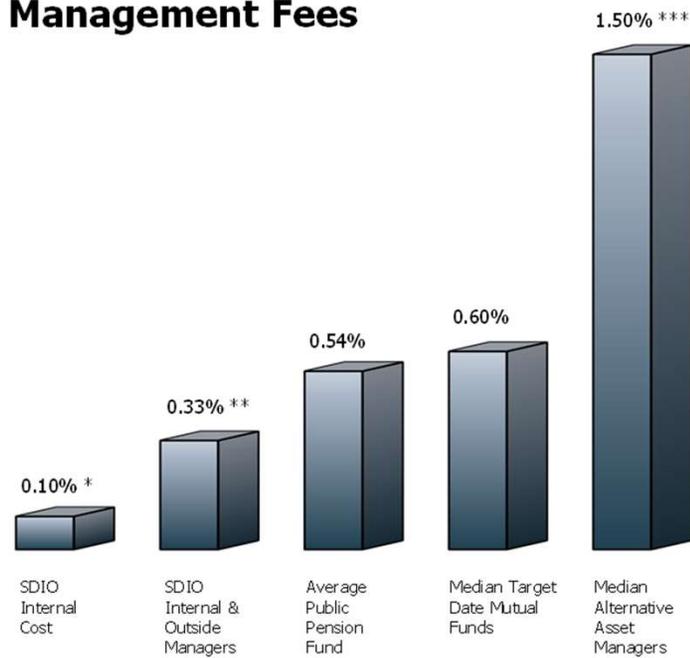
- SDRS preliminary 50-year outperformance = 0.9% annualized vs. benchmark
- Outperformance of .5% next 20 years = extra \$4.8 billion
- Underperformance of .5% = cost to retirement system of \$4.4 billion.

# Many pistons contribute Cumulative Added Value by Source (est for FY23)



# Cost Efficiency

## Management Fees



Difference between SDIC cost of .33% and average public pension fund cost of .54% is \$41.4 million per year, estimated based on Fair Value estimates as of 7/14/23

\* SDIC projected expenses for FY 2025 using adjusted assets and expected average performance incentives.

\*\* Includes estimated external management fees based on average expected investment amounts. Does not include typical 20% profit participation after preferred return for investment partnerships.

\*\*\* Does not include typical 20% profit participation after preferred return for investment partnerships.

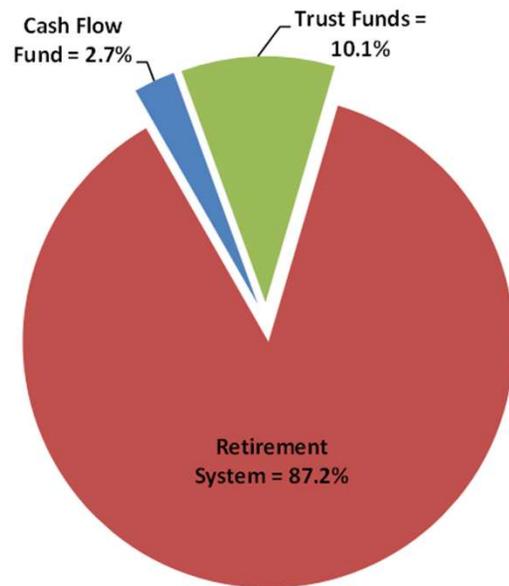
# Compensation Overview

- Long term results have significantly exceeded benchmarks
- Cost efficient due to internal management capabilities
  - Securing team to preserve internal capabilities is best chance to remain cost efficient
  - Internal cost .1% with expected average incentives
- Continued success dependent on high caliber team
  - Internally manage most assets using internally generated research
- Future team depends on retention of talent pipeline and trainers
  - Develop internally as cannot compete for top tier experienced talent
- Compensation plan aligned with goal of adding value over long term
  - Motivate superior long-term performance and retain successful staff

# Compensation Overview, cont'd

- Compensation target
  - Council target is 70% of cost-of-living adjusted median industry pay to balance getting a good deal for South Dakota without losing the good deal if we cannot keep our people
  - Incorporates performance incentives
  - Compensation study updated approximately every three years
- Compensation study 2013
  - Study showed compensation had fallen to 55%
  - Expanded incentive compensation plan as opposed to adjusting base compensation
  - Incentives expanded to include longer term and stretch incentives and expected to average 80% (0% to 200%) -- This reached 95% of 70% target
  - Incentives aligned with the goal of adding value and only paid if add value
- Compensation study 2016 and 2019
  - Indicated moderate slippage, but not sufficient to request adjustment
- Compensation study 2022
  - Indicated further slippage to 10% threshold just sufficient to request adjustment
  - Council recommends increase in incentive maximum to 225% focusing on 10 yr. performance including stretch component. This reduces to half of shortfall.

# Budget Funding Sources



## Preliminary Estimate

- South Dakota Retirement System = 87.2%
- Cash Flow Fund = 2.7%
- Dakota Cement Trust = 2.2%
- Education Enhancement Trust = 4.3%
- Health Care Trust = 1.3%
- School & Public Lands = 2.3%

Budget funded by assets under management

0% General Fund appropriation

Note: S&PL share of SDIC expenses paid from earnings of Cash Flow Fund

# Long-Term Plan Executive Summary

## Projected LTP Budget

<b>INVESTMENT COUNCIL BUDGET</b>	<b><u>FY 2025</u></b>	<b><u>FY 2030</u></b>	<b><u>FY 2035</u></b>
<b>Personal Services</b>			
Number of Employees	35	35	35
Base Compensation - Total Staff	7,897,689	9,648,802	12,051,078
Student Interns	41,948	47,461	53,697
Investment Council	8,125	9,193	10,401
Flexibility funds-Retirements & Resignations	208,370	235,752	266,732
Investment Incentive Maximum	15,063,131	18,936,613	23,591,205
Benefits	3,101,122	3,928,492	4,959,574
<b>Total Personal Services</b>	<b>26,320,386</b>	<b>32,806,312</b>	<b>40,932,686</b>
<b>Operating Expenses</b>			
Contractual Services	2,901,347	3,204,328	3,527,549
Travel	86,431	97,789	110,639
Office Supplies & Postage	5,000	5,657	6,400
Capital Assets	40,520	56,045	63,902
<b>Total Operating Expenses</b>	<b>3,033,298</b>	<b>3,363,819</b>	<b>3,708,491</b>
<b>Total Investment Council Budget <sup>(1)</sup></b>	<b>29,353,684</b>	<b>36,170,131</b>	<b>44,641,177</b>
<b>ASSET SUMMARY <sup>(2)</sup></b>			
Internal Assets	16,229,871,182	19,934,655,213	24,500,288,675
External Assets	5,125,222,479	6,295,154,278	7,736,933,266
<b>Total Assets</b>	<b>21,355,093,661</b>	<b>26,229,809,490</b>	<b>32,237,221,941</b>
<b>EXPENSE SUMMARY</b>			
Internal Expenses	29,353,684	36,170,131	44,641,177
External Manager Fees	56,377,447	69,246,697	85,106,266
<b>Total Expenses</b>	<b>85,731,132</b>	<b>105,416,828</b>	<b>129,747,443</b>
<b>UNIT COST SUMMARY <sup>(3)</sup></b>			
Internal Expenses as % of Total Assets	0.10%	0.10%	0.10%
Total Expenses as % of Total Assets	0.33%	0.33%	0.33%

<sup>(1)</sup> FY 2025 amounts differ from the actual final budget request. To reflect all costs, the LTP includes an assumed salary policy of 2.5% and an additional 1.75% increase for investment positions. The salary policy is not included in the budget request as any salary policy is added afterward.

<sup>(2)</sup> Projections based on long-term assumed returns applied to 6/30/23 assets. Updated each June 30.

<sup>(3)</sup> Unit Cost Summary uses assumed average investment performance incentives

# FY 2023 Budget and Actual

PERSONAL SERVICES	Expended FY 2023	Received FY 2023	Unexpended FY 2023
<b>Total FTEs</b>	32.10	35.00	
<b>Base Compensation</b>			
Base Compensation - Investment Staff	5,416,657	6,494,589	1,077,932 *
Base Comp - Admin, Acct, Legal, Longevity	605,950	739,095	133,145
<b>TOTAL STAFF - FULL TIME</b>	<b>6,022,607</b>	<b>7,233,684</b>	<b>1,211,077</b>
Part-Time - Legal & Interns	70,673	89,429	18,756
Investment Council	2,175	7,197	5,022
Retirement & resignation flexibility funds	0	189,989	189,989
Benefits	1,041,188	1,367,668	326,480
<b>Total Base Compensation</b>	<b>7,136,643</b>	<b>8,887,966</b>	<b>1,751,324</b>
<b>Investment Performance Incentives</b>			
Maximum Potential Investment Perf Incentive	6,808,774	11,848,483	5,039,709
Benefits	357,963	1,435,090	1,077,127
<b>Total Investment Performance Incentives</b>	<b>7,166,737</b>	<b>13,283,573</b>	<b>6,116,836</b>
<b>TOTAL PERSONAL SERVICES</b>	<b>14,303,380</b>	<b>22,171,539</b>	<b>7,868,160</b>
<b>OPERATING EXPENSES</b>			
Contractual Total (see appendix for further details)	2,017,825	2,454,980	437,155
Travel	31,753	86,431	54,678
Office Supplies	2,969	7,000	4,031
Capital Assets	56,299	40,520	(15,779)
<b>Total Operating Expenses</b>	<b>2,108,847</b>	<b>2,588,931</b>	<b>480,084</b>
<b>TOTAL BUDGET</b>	<b>16,412,227</b>	<b>24,760,471</b>	<b>8,348,244</b>

\*Includes \$64,737 Virtus reimbursement & unused compensation

Note: Budget is funded as needed and ended year with a cash balance of \$2,371,791.76 which is credited against FY 2024 authorized budget

# FY 2025 Budget Request

## Summary

PERSONAL SERVICES	<u>Received FY 2024</u>	<u>Request FY 2025</u>	<u>% change</u>
<b>Total FTEs</b>	35.00	35.00	
<b>Base Compensation</b>			
Base Compensation - Investment Staff	6,694,725	6,897,834	3.03%
Base Comp - Admin, Acct, Legal, Longevity	794,708	816,044	2.68%
<b>TOTAL STAFF - FULL TIME</b>	<b>7,489,433</b>	<b>7,713,878</b>	<b>3.00%</b>
Part-Time - Legal & Interns	97,005	40,949	-57.79%
Investment Council	7,927	7,927	0.00%
Retirement & resignation flexibility funds	203,288	203,288	0.00%
Benefits	1,462,228	1,496,554	2.35%
<b>Total Base Compensation</b>	<b>9,259,883</b>	<b>9,462,596</b>	<b>2.19%</b>
<b>Investment Performance Incentives</b>			
Maximum Potential Investment Perf Incentive	14,612,825	15,063,132	3.08%
Benefits	1,816,569	1,578,712	-13.09%
<b>Total Investment Performance Incentives</b>	<b>16,429,394</b>	<b>16,641,844</b>	<b>1.29%</b>
<b>TOTAL PERSONAL SERVICES</b>	<b>25,689,277</b>	<b>26,104,441</b>	<b>1.62%</b>
<b>OPERATING EXPENSES</b>			
Contractual Total (see next page for further details)	2,649,284	2,901,347	9.51%
Travel	86,431	86,431	0.00%
Office Supplies	7,000	5,000	-28.57%
Capital Assets	40,520	40,520	0.00%
<b>Total Operating Expenses</b>	<b>2,783,235</b>	<b>3,033,298</b>	<b>8.98%</b>
<b>TOTAL BUDGET</b>	<b>28,472,513</b>	<b>29,137,739</b>	<b>2.34%</b>
<b>UNIT COST SUMMARY *</b>			
Internal Expenses as % of Total Adjusted Assets	0.100%	0.100%	
Total Expenses as % of Total Adjusted Assets	0.335%	0.335%	

\* Unit cost based on total assets adjusted to long-term value, expenses using assumed average investment performance incentives, long-term average of retirement & resignation flexibility funds, and an assumed 2.5% salary policy for FY25.

# FY 2025 Budget Request

## Contractual services detail

	<b>Received</b> <b><u>FY 2024</u></b>	<b>Request</b> <b><u>FY 2025</u></b>	<b><u>% chng</u></b>
<b>CONTRACTUAL SERVICES</b>			
<b>Investment Services</b>			
Consulting Services	180,000	180,000	0.00%
Investment Accounting, Performance Benchmarking	251,377	427,905	70.22%
Investment Databases, Newsfeeds & Quote Fees	802,063	827,100	3.12%
Investment Research Services	450,910	496,179	10.04%
Flexibility - From Brokerage to Independent Research	225,000	225,000	0.00%
<b>Total Investment Services</b>	<b>1,909,350</b>	<b>2,156,185</b>	<b>12.93%</b>
<b>Administrative Expenses</b>			
Office Rent	168,605	168,605	0.00%
Bond/Liability Insurance	8,385	8,385	0.00%
Telephone	18,000	18,000	0.00%
Office Equip Rental/Maintenance/Misc	7,800	7,800	0.00%
Bureau of Info & Telecommunications (BIT)	111,621	111,621	0.00%
State Central Services	14,828	14,828	0.00%
Legislative Audit	65,351	70,579	8.00%
Janitorial	3,682	3,682	0.00%
Custodial Fees - Global	305,162	305,162	0.00%
Seminars/Educational Programs	35,000	35,000	0.00%
Business Publications	1,500	1,500	0.00%
<b>Total Administrative Expenses</b>	<b>739,934</b>	<b>745,162</b>	<b>0.71%</b>
<b>TOTAL CONTRACTUAL SERVICES</b>	<b>2,649,284</b>	<b>2,901,347</b>	<b>9.51%</b>

# Trust Funds (Preliminary estimates)

## Health Care Trust (established April 2001)

Principal as of 6/30/23	\$ 135,631,024			
Principal as of 6/30/23 adjusted for inflation	\$ 201,008,796			
Fair Value (FV) as of 6/30/23	\$ 216,525,141	<i>Estimate</i>		
Difference - FV less principal	\$ 80,894,117			
Difference - FV less infl. adj. prin.	\$ 15,516,345			
Fiscal year to date return	5.63%	<i>Estimate</i>		
Longterm expected mean return	5.98%			
Payout of 4% plus expected inflation of 2.25%	6.25%			
Expected return cushion/shortfall	-0.27%			
Distribution for FY 24 (July 3, 2023)	7,276,454			
Distribution for FY 23 (July 1, 2022)	6,612,325			
Distribution for FY 22 (July 2, 2021)	5,839,236			

<u>Asset Allocation</u>	<u>Current</u>	<u>FY 23 Benchmark</u>
Global & Private Equity	32%	50%
Real Estate	12%	11%
Fixed Income-IG	14%	30%
Fixed Income-HY	4%	7%
HY RE Debt	0%	0%
Money Market	38%	2%
Total	100%	100%

Law allows up to 4% of the 16 quarter average to be distributed as long as principal is not violated as of December 31 each year.

## Education Enhancement Trust (established April 2001)

Principal as of 6/30/23	\$ 443,645,783			
Principal as of 6/30/23 adjusted for inflation	\$ 689,050,563			
Fair Value (FV) as of 6/30/23	\$ 727,153,577	<i>Estimate</i>		
Difference - FV less principal	\$ 283,507,794			
Difference - FV less infl. adj. prin.	\$ 38,103,013			
Fiscal year to date return	5.70%	<i>Estimate</i>		
Longterm expected return (lower due to tax-exempts)	5.95%			
Payout of 4% plus expected inflation of 2.25%	6.25%			
Expected return cushion/shortfall	-0.30%			
Distribution for FY 24 (July 3, 2023)	26,389,450			
Distribution for FY 23 (July 1, 2022)	25,277,997			
Distribution for FY 22 (July 1, 2021)	23,673,657			

<u>Asset Allocation</u>	<u>Current</u>	<u>FY 23 Benchmark</u>
Global & Private Equity	32%	50%
Real Estate	12%	11%
Fixed Income-IG	13%	24%
Fixed Income-Tax Ex	0%	6%
Fixed Income-HY	4%	7%
HY RE Debt	0%	0%
Money Market	39%	2%
Total	100%	100%

Law allows up to 4% of the 16 quarter average to be distributed as long as principal is not violated as of December 31 each year.



# Investment Performance Incentive – FY 2023 (Preliminary estimate) State Investment Officer

Return-linked compensation maximum is 200% on FY 2023 base compensation of \$556,268 payable in FY 2024. Performance Period is the one year, four year, and ten year annualized fiscal years.

## **60% OF PLAN BASED ON TOTAL FUND RESULTS:**

Range of \$280,000-\$340,000

Performance measurement based on Total Fund results relative to the Capital Markets Benchmark for 1 year, 4 years, 10 years, 4 years stretch, and 10 years stretch.

## **40% OF PLAN BASED ON AGGREGATE PORTFOLIO MANAGERS' RESULTS:**

Range of \$220,000-\$230,000

Performance measurement based on the aggregate return-linked compensation of the assistant investment officers and investment staff divided by the aggregate potential return-linked compensation for the performance period, based on 1 year, 4 years, 10 years, 4 years stretch and 10 years stretch.

## **TOTAL EARNED RETURN-LINKED COMPENSATION:**

**Range of \$500,000-\$570,000**

**Percentage of Salary: 90%-102%\***

\*before reduction for support staff incentive

# Appendix

- Investment performance incentives
- Target discount rationale
- FY23 Budget and Actual - Contractual Services details

# Investment Performance Incentives

## Align compensation with goal of adding value

- Encourage superior performance
  - Counters underperformance career risk that can discourage efforts to add value
  - Multiyear timeframes encourage investing for the long term
- Encourage retention of successful staff
  - Team is most attractive to other organizations when winning
  - Shifts compensation higher when people more sought and down when losing
- Incentives paid only for added value
- Important to encourage adding value in good and bad markets
  - Added value in down markets more important than in up markets
  - Encourages adding value by reducing risk when markets expensive

# Target discount rationale

- Need top caliber people long term
  - Unsuccessful people or job hopppers always available but no bargain, even if free
  - Compensation is too low to recruit veteran high-performers from elsewhere
  - Must develop team internally by training cream of crop local University graduates
  - Takes 15 to 20 years to fully develop seasoned talent
  - If lose talent pipeline or trainers, will jeopardized handoff to next generation
- Our past history and observation of others suggest 70% target
  - Only way to know for sure how large discounts can work is to risk damaging team
  - 50% discount levels in past led to difficulties
  - 30% discount believed significant relative to other high-end professionals
  - Industry subject to intense performance measurement with significant consequences for winning and losing which intensifies desire for financial security
  - Discounts for top SDIC performers may be much larger as industry pay for top quartile performers can be double the median

# FY23 Budget and Actual

## Contractual services detail

	<b>Expended</b>	<b>Received</b>	<b>Unexpended</b>
	<b><u>FY 2023</u></b>	<b><u>FY 2023</u></b>	<b><u>FY 2023</u></b>
<b>CONTRACTUAL SERVICES</b>			
<b>Investment Services</b>			
Consulting Services	4,500	180,000	175,500
Investment Accounting, Performance Benchmarking	202,329	175,451	(26,878)
Investment Databases, Newsfeeds & Quote Fees	705,363	762,722	57,359
Investment Research Services	435,831	419,200	(16,631)
Flexibility - From Brokerage to Independent Research	0	225,000	225,000
<b>Total Investment Services</b>	<b>1,348,024</b>	<b>1,762,373</b>	<b>414,349</b>
<b>Administrative Expenses</b>			
Office Rent	143,950	153,000	9,050
Bond/Liability Insurance	9,510	8,385	(1,125)
Telephone	15,710	18,000	2,290
Office Equip Rental/Maintenance/Misc	3,745	10,031	6,286
Bureau of Info & Telecommunications (BIT)	99,548	97,218	(2,330)
State Central Services	13,260	14,038	778
Legislative Audit	62,739	60,510	(2,229)
Janitorial	0	0	-
Custodial Fees - Global	292,140	293,425	1,285
Seminars/Educational Programs	28,496	35,000	6,504
Business Publications	703	3,000	2,297
<b>Total Administrative Expenses</b>	<b>669,801</b>	<b>692,607</b>	<b>22,806</b>
<b>TOTAL CONTRACTUAL SERVICES</b>	<b>2,017,825</b>	<b>2,454,980</b>	<b>437,155</b>